Supreme Court of the United States

OCTOBER TERM, 1942.

No. .....

O'BRYAN BROTHERS, PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

JURISDICTION.

The opinion of the United States Circuit Court of Appeals for the Sixth Circuit is printed on pages.....to..... of the record and has not yet been officially reported. The opinion and judgment of the United States Circuit Court of Appeals were handed down and entered on April 16, 1942.

II.

STATEMENT OF THE CASE.

There are two questions involved in the case:

1. Was the surrender of the collateral voluntary or involuntary?

2. What was the value of the common stock per share at the time of the surrender?

It is petitioner's insistence that the collateral was not voluntarily surrendered but was released involuntarily under economic compulsion and that petitioner consented to the release of the collateral upon the demand of the bank in order to prevent bankruptcy and dissolution.

It may be assumed in considering the first question that the finding by the Board of Tax Appeals that the common stock had a value of $150 per share was supported by substantial evidence. Assuming this valuation, the collateral retained by the petitioner after the surrender of the 751 shares of common stock had a total value of $118,550 (557 shares at $150 per share plus $35,000, the value of the real estate), thereby resulting in an ascertained loss of $90,017.20 which, under the Board's findings, would completely eliminate all net profit for the year 1933 so that no deficiency tax could be assessed.

If this question is resolved in favor of petitioner's contention, the second question will become immaterial.

III.

SPECIFICATION OF ERROR.

1. The United States Circuit Court of Appeals for the Sixth Circuit erred in holding that O'Bryan Brothers voluntarily released 751 shares of its common stock held as collateral to the indebtedness and that the partial loss

resulting therefrom was caused by its own voluntary act. The undisputed proof shows that said release was made under economic compulsion, with no alternative other than bankruptcy and dissolution, and hence such release was involuntary.

2. There is no substantial evidence to support the findings of either the Board of Tax Appeals or the Circuit Court of Appeals that the stock in question was reasonably worth $150 per share.

IV.

ARGUMENT.

The underlying principle upon which the Circuit Court of Appeals disallowed the deduction against Kennedy, Sr., was that the debt became partially worthless because of the petitioner's own voluntary surrender of a portion of its collateral.

It is well settled that a taxpayer cannot claim a loss resulting from its own forgiveness of a debt or from its voluntary surrender of collateral.

But it is equally well settled that the cancellation of the debt or the surrender of collateral through economic compulsion in order to escape greater losses through threatened financial ruin is not a voluntary cancellation of indebtedness or surrender of collateral. The courts have taken a realistic view of such a factual situation as the one presented by the undisputed evidence in the present case and have consistently held that one who is forced to give up security in a desperate effort to keep a business going does not commit a voluntary act contributing to its loss but acts involuntarily with no reasonable choice and any loss ensuing is deductible provided the act was taken in good faith.

In *Commissioner of Internal Revenue* v. *Wright*, 47 F. 2d 871, a corporation became involved in financial dif-

ficulties and was largely indebted to a bank. As in the present case, the bank refused to continue to carry the indebtedness and threatened bankruptcy proceedings unless each stockholder surrendered to the banker fifty-one percent of their stock for the purpose of transferring it absolutely to a new manager of the corporation as compensation for his services in attempting to save the business. The Circuit Court of Appeals for the Seventh Circuit, in an opinion by Alschuler, Circuit Judge, held that the surrender of the stock was not voluntary and remanded the case to the Board of Tax Appeals to compute and allow the actual loss sustained by the stockholders.

In *Commissioner of Internal Revenue* v. *Burdick*, 59 F. 2d 395, the Circuit Court of Appeals for the Third Circuit stated the situation as follows:

> "The company fell into financial difficulties so that the need of fresh capital and of new management was felt. A man by the name of Louis C. Kunz was willing to step into the breach upon terms satisfactory to him and decedent. These terms included the furnishing by Kunz of $40,000."

The decedent taxpayer surrendered a large portion of his stock in order to procure new management for the corporation in its financial stress, and the Circuit Court of Appeals for the Third Circuit allowed the resulting loss even though the surrender was voluntary, saying:

> "All he had done was to part with a part and a large part of what he had formerly owned. * * * The real and only consideration he received was the expectation that under the management of Kunz the retained stock of the taxpayer would have an enhanced value."

The reasoning underlying the above conclusion was that one who surrenders value in a crisis in the hope of salvaging a retained interest is entitled to a deduction for the resulting loss if the transaction was in good faith.

In *Deeds* v. *Commissioner of Internal Revenue*, 47 F. 2d 694, the Circuit Court of Appeals for the Sixth Circuit, in considering a similar situation, said:

> "The proper answer to this question depends, we think, upon the purpose and reasonableness of the action taken. It cannot be used as a subterfuge, merely to avoid the payment of taxes, nor as a means of benefaction or bounty; but, if the step be taken in the interest of the taxpayer, in the exercise of an experienced business judgment, and in an effort to avoid even greater and otherwise certain losses, we cannot see that the taxpayer should be precluded from taking the deduction, because the amount of the loss then to be suffered was thus definitely ascertained, and the fact of such partial loss made certain by the action of the taxpayer himself. The facts are none the less clear that, after cancellation, the debts were in fact worthless, were realized to be so by the taxpayer, and were charged off on his books.
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> "This was not the ordinary case of mere forgiveness of indebtedness. It was not a gift. It was the performance of an act which highly experienced and skillful business men honestly believed to be to their own best interests in the avoidance of loss and therefore to the interest of the government in maintaining income. But it nevertheless was an event which definitely and permanently prevented the collection of the debt."
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> pp. 697, 698.

In the opinion in the present case Allen, Circuit Judge, sought to distinguish the present case from *Deeds* v. *Commissioner, supra,* on the ground that there was no showing in the present case that the debtor was insolvent in the first instance and the debt uncollectible because of such insolvency. It is said that as the owner of 1,308 shares of stock *"in this going concern"* Kennedy, Sr., was not insolvent at the time of this transaction because the collateral had substantial value.

This statement completely overlooks the undisputed fact that O'Bryan Brothers could continue as a going concern only in the event Kennedy, Sr., and O'Bryan Brothers surrendered 751 shares of the collateral. If this had not been done the American National Bank would have withdrawn its guaranty of the corporation's outstanding indebtedness and would have demanded payment of the indebtedness due it, and admittedly the result would have been bankruptcy and liquidation.

At this time the book value of the common stock was approximately $70 per share (see Respondent's Exhibit "A"). The common stock had a value of only $70 or $75 assuming an orderly liquidation (R. 70). It had no market value and there were no sales for a number of years prior to 1932 or 1933 (R. 73, 77, 78). As testified by Kennedy, Jr.:

> "It had absolutely no actual value from the standpoint of sales in 1933. It could not have been sold for any sum. We were operating on what was practically a receivership."
> (R. 69).

Admittedly Kennedy, Sr., was individually insolvent. Unless he and the corporation agreed to surrender 751 shares of the common stock the collateral would have been worth only what might reasonably be expected for the stockholders in bankruptcy. This Court cannot close its eyes to the fact that in June, 1933, at the conclusion of the Bank Holiday, we were in the midst of a world depression and to the further inescapable fact that stockholders would have received absolutely nothing in a bankrupt distribution and it is doubtful whether creditors would have been paid in full. The Board of Tax Appeals and the Circuit Court of Appeals under these circumstances valued the common stock on the basis of its *previous earnings* and concluded that it had an actual value of $150 per share, a conclusion which disregards the

undisputed facts and completely ignores the impending dissolution of the corporation.

The petitioner had to make an immediate decision in a financial crisis. Assuming that it might reasonably have expected to receive as much as $60 per share in liquidation, if it refused to surrender any of its collateral, the total collateral would have yielded $78,480 on the common stock plus $35,000 on the residence, or a total of $113,480, which, deducted from the indebtedness of $208,000, would have left a loss of approximately $95,000. On the other hand, assuming the stock to have a going value of $150 per share, as found by the Board of Tax Appeals, by surrendering 751 shares of the collateral at this value and valuing the 557 shares of stock retained as collateral on the same basis, the petitioner's loss would have been approximately $89,000. In either event no deficiency assessment could be sustained since either loss completely eliminated the profits thereafter fortuitously and unexpectedly resulting from a tornado plus the temporary inflation from the introduction of the N. R. A.

It is therefore respectfully insisted that the court erred in holding that petitioner's act was voluntary and that it contributed to its own loss by such voluntary action. It should also be noted that the Board of Tax Appeals has uniformly held that a surrender of indebtedness or collateral in an effort to save a failing corporation does not prevent the establishment of a deductible loss.

City Builders Finance Co., 21 B. T. A. 800.
Robert Gaylord, Inc., 41 B. T. A. 1119.

In *Robert Gaylord, Inc., supra,* the donation of funds to a failing bank by a local business concern which owned no interest in the bank, made for the purpose of avoiding the economic consequences of a local bank failure, was allowed as an ordinary business expense, the Board of Tax Appeals, in its opinion, saying:

> "If the guaranty had not been raised and the apprehended collapse had occurred, it is entirely pos-

sible that petitioner's business would have been wiped out."

p. 1125.

It is earnestly insisted that the decision of the Circuit Court of Appeals for the Sixth Circuit in the present case is based upon controlling principles which are contrary to those announced by the Seventh Circuit in the Wright case, by the Third Circuit in the Burdick case, and by the Sixth Circuit in the Deeds case, and it is important that this Court take jurisdiction in order to resolve the conflict between these courts. It is also insisted that the question of surrendering collateral through economic necessity and the deduction of consequent losses involves an important question of Federal law which has not been, but should be, settled by this Court.

CONCLUSION.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, and that to such an end a writ of certiorari should be granted, and this Court should review the decision of the United States Circuit Court of Appeals for the Sixth Circuit and finally reverse it.

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